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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **July 2008, London**

Project: **D24 *Customer Contributions* – Whether the entity that receives the contribution has an obligation once connection has been made (Agenda Paper 4B)**

Introduction

1. Most respondents to D24 raised revenue recognition issues and asked the IFRIC to clarify these issues.

2. Some (including utility companies) pointed out that, for example, when a utility company is required by law or regulation to provide access to a supply of a commodity to all customers at the same price, the access provider does not have any further obligation once the connection has been made.

3. Many respondents (CL18, CL25, CL42, CL45) believed that an obligation to provide ongoing services to the customer who contributed the asset exists only if the customer obtains in exchange some exclusive right of access to goods or services, eg at a reduced price.

4. One respondent (CL 32) also suggested using the guidance in paragraph 12 of IAS 18 for the exchange of dissimilar goods or services as a conceptual basis to support the proposed accounting for contributions of both PP&E and cash.

Staff analysis

5. The staff think that the IFRIC should discuss further whether the entity that receives the contribution has an obligation once connection has been made.
6. In Section A of this paper, the staff discuss the issue of *customer contributions for connection to a price-regulated network* because this was the issue initially submitted to the IFRIC.
7. In Section B of this paper, the staff discuss the similarities/differences of some Illustrative Examples in IAS 18 with the issue of customer contributions for connection to a price-regulated network.

Section A—Customer contributions for connection to a price-regulated network

8. The staff have prepared the following example using the fact pattern set out in the comment letters of utility companies (eg CL28), the request submitted to the IFRIC and the background section of Interpretation 1017 *Developer and Customer Contributions for Connection to a Price-regulated Network* issued by the Australian Accounting Standards Board in November 2004.

   <u>Example A</u>:

   A real estate company is developing a residential real estate in a remote area that is not connected to the electricity network. In order to have access to the electricity network, the real estate company is required to construct an electricity substation that is then contributed to the utility company operating the electricity network. The contributed electricity substation becomes an asset of the utility company that it must maintain or replace at its cost. The utility company uses the contributed asset to connect each house of the residential real estate development to its electricity network. The developer then sells the connected houses to customers at a price that includes a share of the costs of the electricity substation. By law or regulation, the utility company has an obligation to provide ongoing access to the electricity network to all connected customers at the same price, regardless of whether they have contributed an asset. Customers can choose to purchase their electricity from suppliers other than the utility company, but the utility company always provides the distribution. In that event, the electricity supplier charges the customers quarterly for the consumption of electricity and collects an ongoing access fee on behalf of the utility company.

   <u>Example B</u>:

   Same as Example A but the utility company constructs the substation and receives a cash contribution from the developer that covers part of the cost of the substation. The substation remains however an asset of the utility company.

9. The staff think that, in these circumstances, the issues are:

   - What is the electricity substation contributed for?
   - Can the transaction be analysed as an exchange transaction of dissimilar goods or services under IAS 18?
   - When and how should the utility company recognise revenue?
   - What if the consideration received is a cash contribution?
   - How D24 would apply to Example A and Example B?

What is the electricity substation contributed for?

10. In Example A, the consideration received by the utility company is in the form of an asset (the substation). In exchange for the substation, the utility has an obligation to *connect the houses to the electricity network*. To fulfil its obligation, the utility has to provide connection services that are clearly identifiable and represent value for the developer or the eventual homeowners (a connected house has more value than a non-connected house).

11. By law or regulation, the utility company has an ongoing obligation to provide access to the electricity network to *all connected* customers at the same price, regardless of whether they have contributed an asset. For this reason, the staff think that this obligation is unrelated to the contribution. Once a customer is connected, the utility company provides ongoing access to its network, regardless of whether the customer purchases its electricity from the company, and charges the customer a quarterly fee for the ongoing access during that period.

12. The utility company has to maintain the contributed asset (the substation) in good order and eventually to replace it at its cost, regardless of whether the current customer is the initial contributor. In Example A, the contributed asset is an asset for the utility company and meets the definition of PP&E: the substation is held for use in the production or supply of a service (ie to distribute electricity from the electricity network to the houses) and is expected to be used during more than one period. In these circumstances, the maintenance activity and the obligation to provide ongoing access to the distribution network do not meet the definition of a liability. No liability should be recognised for the obligation to these customers, unless a liability is recognised for the similar obligation to all connected customers.

13. Therefore, in Example A, the staff's view is that the only service that can be identified in exchange for the substation is the provision of initial access (or connection) to the electricity network.

Can the transaction be analysed as an exchange transaction of dissimilar goods or services under IAS 18?

14. The staff note that paragraph 12 of IAS 18 states that ‘when goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred.’

15. The staff also note that the IFRIC discussed exchange transactions of dissimilar goods or services in the context of IFRIC 12 *Service Concession Arrangements*. Paragraph BC34 of IFRIC 12 notes that an identifiable service (the construction of infrastructure) is rendered in exchange for an asset (an intangible asset).

16. In Example A, the staff’s view is that the utility company provides a service (the connection to the electricity network) in exchange for an asset (the substation). The utility company then uses the connected substation to provide ongoing access to the network and therefore generate cash revenues from the future homeowner(s).

17. A few respondents to D24 asked the IFRIC to clarify whether either the indicator of *control* or the indicator of *risks and rewards* was predominant when determining whether a customer contribution qualifies as an asset for the entity that received the contribution. The staff’s view is that both criteria must be satisfied for the contribution to meet the definition of an asset — ‘a resource *controlled* by an entity … from which *future economic benefits* are expected to flow to the entity.’ (see paragraph 49(a) of the *Framework*). In Example A, the utility company has received a good (the substation) from the developer. It will manage that substation as part of its distribution network, maintaining it or replacing it as necessary. It will benefit by receiving fees for providing access to the network and revenue for providing distribution services.

When and how the utility company should recognise revenue?

18. Paragraph 13 of IAS 18 requires the recognition criteria to be applied to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.

19. In Example A, the staff identified two services:

    (a) An initial service provided to the developer (the contributor), ie the initial access (connection) to the electricity network in exchange for the substation;

    (b) An ongoing service provided to the developer and the future homeowner(s), ie the provision of ongoing access to the network at a regulated price.

20. If the utility company entered into a single agreement with the contributor for both the initial and ongoing service, revenue should be recognised when each of these services is rendered in accordance with paragraphs 13 and 20 of IAS 18. The fair value of the consideration received for the initial service is the fair value of the asset exchanged for that service, eg the fair value of the substation in accordance with paragraph 12 of IAS 18.

What if the consideration received is a cash contribution?

21. The staff agree with the IFRIC's view set out in BC23 of D24: 'The IFRIC noted that the economic effect of a cash contribution was similar to the effect of a contribution of property, plant and equipment.' The staff think that an exchange transaction of cash for a service (Example B) should be accounted for similarly to an exchange transaction of a good for a service (Example A).

How D24 would apply to Example A and B?

22. The staff agree with respondents that the scope of D24 is very wide as it covers 'all situations in which an entity receives an item of property, plant and equipment or cash it is required to use to construct or acquire an item of property, plant and equipment that must be used to provide access to a supply of goods or services' (see paragraph 4 of D24).

23. In contrast, the staff note that paragraph 16 of D24 states that ‘the period over which revenue is recognised shall be the period over which the entity has an obligation to continue to provide access to a supply of goods or services using the contributed asset.’

24. The staff note that, in BC17 of D24, the IFRIC considered three possible alternatives obligations that might arise as a result of the customer contribution:

    (a) The obligation arises as a result of the supplier agreeing to provide goods or services to the customer at a reduced price in the future.

    (b) The obligation is to provide a connection to a network supplying goods and services. Once that connection has been made, the obligation is settled.

    (c) The obligation is to provide an ongoing access to a supply of goods or services.

25. The staff think that, in Example A and B, alternative (a) above does not arise because customers that make a contribution pay the same price for ongoing services as those that do not. In these circumstances, the staff agree with the IFRIC’s reason for rejecting alternative (a) set out in the first sentence of paragraph BC18 of D24. However, there may be transactions in which such an obligation exists. The staff think that it was not the intention of the IFRIC to deal with such transactions because IFRSs already provide guidance on the accounting for such an obligation.

26. The staff think that, in Example A and B, once connection has been made, the obligation is settled. However, the IFRIC rejected alternative (b) in BC18 because, ‘in many cases, once the supplier receives the asset it has a continuing obligation to use the asset to provide customers with access to a supply of goods or services’. Only alternative (c) was considered as valid by the IFRIC: ‘the obligation is to provide an ongoing access to a supply of goods or services’. In its comment letter analysis (see agenda paper 4A), the staff noted that respondents to D24 were not convinced by the IFRIC’s conclusion even though the IFRIC was careful to point out that the duration of that obligation might be very short.

27. In conclusion, the staff think that there are two views in respect of Example A and B:

- View 1: the only service identified in exchange for the substation or the cash contribution is the provision of initial access (connection) to the electricity network. Revenue should be measured at the fair value of the consideration received and recognised when the connection services are performed; and

- View 2 (view held in D24): once the utility company receives the substation or a cash contribution, the utility company has the continuing obligation to use the substation to provide customers with access to a supply of electricity (see paragraphs 11 and 22 of D24). The period over which revenue is recognised should be the period over which the utility company has an obligation to continue to provide access to a supply of electricity (see paragraph 16 of D24).

28. For the reasons explained in Section A of this paper, the staff support View 1.

Section B — Discussing Illustrative Examples in IAS 18

29. In the Appendix to IAS 18, the staff identified the following examples that have similarities/differences with the issue of customer contributions for connection to a price-regulated network.

- Paragraph 10 of the Appendix to IAS 18 - *Installation fees*

> Installation fees are recognised as revenue by reference to the stage of completion of the installation, unless they are *incidental* to the sale of a product, in which case they are recognised when the goods are sold. (Emphasis added)
>
> <u>Staff's comment</u>: in Example B, the connection to the electricity network is a service that is essential to the provision of ongoing access to the supply of electricity. No revenue from the provision of ongoing access will flow to the utility company without connection to the network. Therefore connection services are not *incidental* to the provision of ongoing access.

- Paragraph 17 of the Appendix to IAS 18 - *Initiation, entrance and membership fees*

  > Revenue recognition depends on the nature of the services provided. If the fee permits only membership, and all other services or products are paid for separately, or if there is a separate annual subscription, the fee is recognised as revenue when no significant uncertainty as to its collectibility exists. If the fee entitles the member to services or publications to be provided during the membership period, or to purchase goods or *services at prices lower than those charged to non-members*, it is recognised on a basis that reflects the timing, nature and value of the benefits provided. (Emphasis added)

  > <u>Staff's comment</u>: in Example B, the initial and ongoing services are separately identifiable, paid for separately and provided at different times. The ongoing fee is the same for each customer, which is a different situation as highlighted in the example above.

- Paragraph 18 of the Appendix to IAS 18 - *Franchise fees* (b) *Supplies of initial and subsequent services*

  > Fees for the provision of continuing services, whether part of the initial fee or a separate fee, are recognised as revenue as the services are rendered. When the separate fee does not cover the cost of continuing services together with a reasonable profit, part of the initial fee, sufficient to cover the costs of continuing services and to provide a reasonable profit on those services, is deferred and recognised as revenue as the services are rendered.

  > <u>Staff's comment</u>: in Example B, the utility company charges an ongoing fee that is the same for each customer. This fee covers the depreciation of regulated assets but may not cover the depreciation of contributed assets. It could be argued that part of the consideration received for the service connection to the network should be deferred to provide a reasonable profit on the ongoing access services. However, applying View 1 would lead to measuring revenue from the connection services at the fair value of the asset or cash received for these services and recognising revenue when the connection services are performed. Contributed assets may be impaired as a result of applying IAS 36 *Impairment of Assets*.

30. The staff note that the conclusion reached in paragraph 28 of this paper (View 1) is consistent with the existing guidance in IAS 18 when the facts and circumstances are similar. In other facts and circumstances (eg the supplier agreeing to provide goods or services to the customer at a reduced price in the future), the staff think that IFRSs already provide guidance.

31. Therefore, it seems to the staff that the Interpretation should give guidance on the accounting for the receipt of customer contributions only when the entity that

receives a contribution from a customer has no obligation to this customer that is different from its obligation to the customers who did not contribute.

Questions to IFRIC members

32. The staff would like to ask IFRIC members the following questions:

- In paragraph 27 of this paper, the staff present two views. In paragraph 28, the staff support View 1. Which view do you support (View 1 or View 2)?
- Do you have any comments on the discussion set out in Section B of this paper?
- Do you think the IFRIC should continue its work on this issue? If so, what should be the scope of the project?